Interview by Vinson & Elkins
with Larry Grissom

at footnote(s):

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FINAL

M E M O R A N D U M

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TO: Paul S. Maco
Richard C. Sauer

FROM: Benjamin S. Lippard

RE: *City of San Diego*; Interview of Larry Grissom

This memorandum summarizes the interview of Larry Grissom. This memorandum does not contain a verbatim or a near-verbatim transcription of this interview, but rather is a general summary of my thoughts and mental impressions regarding our discussion. Significantly, it is organized to summarize issues thematically and does not reproduce the order in which the interview actually occurred. There was no stenographer present at this interview, and given the nature of summarizing this type of discussion after the fact, this memorandum does not attempt to describe every statement or exchange and it is possible that there are errors in this account. It also assumes familiarity with the facts of this case, and does not provide context or explanation of every factual reference. Nor does it address issues of credibility or attempt to reconcile any differences between this interview and the accounts of other individuals.

This memorandum is subject to the attorney client and the attorney work product privileges, as it was prepared in connection with our providing legal advice to the City of San Diego (the "City") in connection with a potential SEC investigation regarding some of the matters discussed in this memorandum.

At the beginning of this interview, Mr. Sauer explained to Mr. Grissom that we represent the City in connection with both an internal investigation regarding the City's financial statements and bond disclosures as well as an SEC investigation touching on those same matters. Mr. Grissom is represented by an attorney, Mike Leone, who was present for this interview.

General overview of interview. Richard Sauer and I met with Mr. Grissom for approximately two hours on the morning of April 22, 2004. Mr. Grissom was helpful and willing to answer our questions. The discussion began with general discussion of Mr. Grissom's position and CERS reserve accounting and actuarial assumptions. It then turned to City contributions to CERS, including the "pick up," and Mr. Grissom explained how that contribution is calculated. The next topic was "surplus earnings," which Mr. Grissom explained at length. Mr. Grissom then explained retiree health benefits, including how the City began offering that benefit, complex tax issues that govern that benefit, and projections that had been done to estimate the cost of that benefit. Finally, Mr. Grissom explained his views on the purposes and structure of MP I. The interview concluded because Mr. Grissom's attorney had an appointment; Mr. Grissom has much additional information that will be of interest to us.

Background. Mr. Grissom is the Retirement Administrator for CERS and has held this position for 17 years, beginning in July 1987.

CERS reserve accounts. Mr. Grissom explained that a public retirement system must maintain three separate reserve accounts in order to function: one for employer contributions, one for employee contributions, and one for retiree benefits. According to Mr. Grissom, other reserve accounts are optional and serve various purposes. For example, the accounting rules have changed and now require acknowledgement of discrete liabilities on the balance sheet, which are presented as reserve accounts.

Prior to 1980, the majority of the reserve accounts currently maintained by CERS did not exist. Mr. Grissom explained that some, but not all, of these reserve accounts are actually funded with dollar amounts. Mr. Grissom explained that the retiree benefits reserve is simply a calculation done by the actuary, reflecting the accrued (projected) benefits payable to all individual retired employees. The employee contribution reserve is a hard dollar account containing the funds that the City employees have contributed over a given period of time, with interest thereon. Mr. Grissom also explained that the employer contribution reserve is in part a hard dollar account containing the City's contributions and earnings and partly an accounting category representing "surplus earning" retained within the system. The employer, employee and drop reserve accounts are credited with an 8% return each year, reflecting the actuary's assumption for investment returns for the year.

CERS actuarial assumptions. Mr. Grissom explained that the CERS return assumption of 8% was typical for public retirement systems and that investment assumptions typically range from 6.775% to 8.5%. He also explained that some systems had used assumptions as high as 9% during the mid 1990's, and that one company, GM, had even used a return assumption of 11.5%. As a result of this high return assumption, GM had to make a large contribution to its pension fund when that target was not met. According to Mr. Grissom, CERS is about in the middle of the pack in terms of its investment return assumption.

Mr. Grissom stated that, in theory, it is the CERS Board's responsibility to approve the actuarial rate for City contributions. This duty is specified in the Municipal Code. He noted, however, that MP II provides that the Board will not change its actuarial assumptions until 2009, and also noted that in other cases the Board has phased in changes to the actuarial assumptions over time. Mr. Grissom stated that, in theory, the actuary should review his assumptions every few years. Mr. Grissom also explained that the California Administrative Code regulates retirement boards throughout the state, and contains some requirements related to actuarial matters.

Mr. Grissom's view is that the actuary is only a hired expert and that the Board has no obligation to accept his views. If the Board does not accept the actuary's views, however, it should explain why it did not.

City contributions to CERS. Mr. Grissom explained that since about 1982, in addition to its own required contributions, the City has also been paying part of the employee contributions. The City's payment of employee contributions is called the "pick-up." The pick-up contributions are accounted for as employer contributions, because the pick-up amounts are not available to employees upon termination (as employee contributions are). Mr. Grissom noted that the City has fully paid the calculated pick-up amount, with a small discount for employee termination. Mr. Grissom also noted that there is no reserve for the pick-up contribution at CERS, but there may be in the City budget. According to Mr. Grissom, the pick-up is actuarially neutral.

The City makes a contribution to CERS on July 1 of every year and this contribution includes the employer contributions, the pick-up, and contributions related to the DROP accounts. This contribution is made by wire transfer as a lump-sum payment.

The City's contribution is calculated by the actuary, who first calculates the "normal cost." "Normal cost" is the payment made in the current year for the benefits that accrue during that year. Then, the actuary adds the amortization of past service liability (for example, retroactive benefit increases that were not covered by past contributions) and the UAAL. These amounts are added together and determine the employer contribution rate. The employer contribution rate, however, is subject to the contribution agreements contained in MP I and MP II. Mr. Grissom also noted that the pick-up is calculated separately.

Mr. Grissom explained that, after the City's initial contribution for the year, there is a balancing transaction made every pay period to adjust the contribution amounts. If the contribution made for that pay period was too small, the City allocates additional funds; if there were surplus contributions, those funds go to covering current administrative expenses.

"Surplus earnings." Mr. Grissom explained that the concept of "surplus earnings" was originally implemented in the early 1980's. According to Mr. Grissom, this concept is not appropriate for a pension fund as a conceptual matter – given the nature of pension funding, no earnings can be truly considered "surplus" – but it is used throughout California, in approximately 30 public retirement systems.

Mr. Grissom provided some historical background to explain how this concept had developed. Before 1984, California public retirement systems were forbidden by the Government Code from investing in stocks. Thus, the administration of these retirement systems was straightforward. The system purchased bonds, which were then held to maturity. The bond coupon rate, for example 4%, would be the actuarial investment return assumption. In the 1970's, however, fluctuations in the bond market allowed retirement systems to increase their returns over the bond coupon payments. For example, bonds paying 4% coupons could be managed to yield annual returns of 4.5% or 5%. Mr. Grissom explained that some systems viewed such increased returns as extra money. Ultimately the Government Code was amended to allow for public retirement systems to invest in stocks, which further increased the potential return on investments. Mr. Grissom explained that before 1980, pension accounting was almost a clerical function, but the increased returns described above allowed the City to lower its contributions.

Mr. Grissom explained that in the early 1980's, retirees typically had a 1% COLA. As a result, their benefits were being substantially eroded by inflation. Because of the increases in investment returns described above, the City Counsel invented the "13th check" payment to make up some of these losses to retirees. This system had some unforeseen consequences, however. By 1984, the 13th check payment divided $12 million among 3,000 retirees. As a result of this very generous payment, the Board decided to cap the amount of the 13th check. This resulted in the *Andrews* litigation, which was ultimately settled. But the *Andrews* litigation created the definition of "surplus undistributed earnings," which built the foundation that ultimately led to the City's current "Waterfall" system.

Effect of the "surplus earnings" concept. Mr. Grissom agreed that the actuary's 8% return assumption is intended to use surplus investment returns in good years to balance out low investment returns in bad years. According to Mr. Grissom, the erosion of this principle was the first step to the "perfect storm" that led to the City of San Diego's pension issues. Mr. Grissom stated that he had a professional problem with the "surplus earnings" concept because the siphoning off of returns presents a problem for system funding. He noted that once excess funds are siphoned off, returns must be higher than the 8% assumption in order to meet the earnings implied by that target. Mr. Grissom noted, however, that until 2000 this was not a problem because CERS assets were yielding an annual rate of return of 15%. Given this, the CERS return assumption was conservative enough to allow headroom for the contingent benefits. He also stated that he does not believe that the diversion of surplus earnings renders the actuary's assumptions invalid.

Mr. Grissom stated that, while in "actuarial nirvana" the calculations would be quite mechanical, in the real world actuarial assumptions are affected by external considerations. He provided an example of this: a Supreme Court decision that a retirement system could not use different contribution rates for males versus female employees despite the fact that – as a purely actuarial matter – female employees typically received higher benefits due to longer lifespan and, as a result, should have paid a higher contribution.

Mr. Grissom also explained that actuaries look for trends and that, as a result, the assumptions change slowly. The CERS system since 1984 has been subject to significant benefit changes. These benefit changes result from the "meet and confer" process, and active employees know that these increased benefits are coming and may change their behavior accordingly (*i.e.*, employees delaying retirement until benefits are passed). Actuaries tend to wait for a period of time to confirm that changes in employee behavior represent real trends as opposed to short-term anomalies.

Mr. Grissom stated, however, that the 8% return assumption does not explicitly take into account the asset diversions being made from the CERS system. Rather, the 8% return assumption derives from the reliable statistics on investment/capital markets performance that date back to 1926. He explained that the CERS investment managers perform asset/liability calculations. According to Mr. Grissom, the investment managers produce more accurate calculations on the asset side, while the actuary produces better calculations on the liability side. Mr. Grissom stated that it would be theoretically possible to adjust the 8% assumption to account for the recent substandard performance of investment markets. To be consistent, however, using such an approach would also have required that the return assumption be raised to account for the approximately 12% returns that occurred during the preceding 10 years. Rather than adjusting the actuarial assumptions to address such fluctuations, Mr. Grissom viewed the 8% assumption as reasonable, even in the current market climate.

Causes of pension problems. Mr. Grissom stated that the City of San Diego's problems resulted from what he called "the perfect storm." According to Mr. Grissom, there were several key factors that led to this phenomenon. The great investment performance of 1990's masked the continuing drain on CERS assets from diversion of earnings to fund contingent benefits, as well as the increases in liability associated with benefit increases. Moreover, new liabilities that had not been anticipates and accrued for significantly affected the funding ratio. Mr. Grissom noted that in the 2000 valuation, the CERS funding ratio was 105%. But after the *Corbett* case created approximately $250 million in new liability, the CERS funding ratio fell from 105% to 97%, a significant drop.

More generally, Mr. Grissom explained that unanticipated events that negatively affect a pension system can be dramatic, can happen very quickly, and take a long time to recover from. In contrast, positive changes in the system take a long time to manifest themselves.

Social Security opt-out. Mr. Grissom stated that whether the City's decision to opt out of Social Security was positive or negative for the system is a matter of opinion. But Mr. Grissom himself thinks it was a good idea. He noted that the City of San Diego was the last City to opt out of Social Security before the federal regulators changed the rules. Mr. Grissom explained that in order to opt out of Social Security, there was a two year waiting period during which the federal regulators determined whether the proposed benefits provided by a city would be sufficient to protect the employees. Mr. Grissom explained that in 1982, Medicare contributions were dependant on whether or not a City was involved in Social Security, and explained that the opt-out was probably good for the City because even though the City has some problems now, it would be much worse if they had to contribute an additional 6% of payroll to cover additional benefits. As a result, it would be more expensive for the City to be in the system.

Post-retirement health benefits. Mr. Grissom stated that from 1982 to about 1994 the health care premiums were paid from undistributed earnings. In 1987, Mr. Grissom learned that IRS regulations do not allow funds contained in a § 401(a) plan to pay for the benefits associated with a § 401(h) plan. The § 401(a) plan is for pension benefits and the 401(h) plan relates to health benefits. Mr. Grissom stated that it took a long time to fix this issue because the City Charter had to be amended to state that post-retirement health care is a "retirement" benefit. Mr. Grissom stated that while this has led many people to believe that the post-retirement healthcare benefits are the responsibility of CERS, that is not accurate. CERS deducts money for these payments, but it does not administer the health care benefits, a function that is performed by the City Risk Management Office. The Municipal Code is specific on this point and states that these benefits are initially paid from surplus earnings; if those earnings are not adequate, the benefit is paid from a reserve; and if the reserve is depleted, the benefit must be paid by the City.

The City pays for the health care benefits on a "pay as you go" basis and has never actuarially funded the health care benefit. Mr. Grissom explained that 95% of other cities do not actuarially fund this either, and noted that there is no requirement to do this under GASB. It is common, however, for cities to reserve against these costs. As an aside, Mr. Grissom also noted that the City provides very generous retirement health care plans.

He noted that the § 401(h) reserve is only funded through surplus earnings in the waterfall process. Mr. Grissom noted that the City's payments for the health care reserve must be split off before a contribution is made to the system to comply with IRS requirements regarding the § 401(a) and § 401(h) plans. Mr. Grissom noted the City is obligated to fund a § 401(h) reserve for health benefits, but that the Municipal Code says that this reserve is to be funded through the "Waterfall" process. Mr. Grissom noted that the reserve increased for a period of years because surplus earnings were greater than premium pension costs. That was not true in recent years, however.

Mr. Grissom explained that last year the CERS Board created a Section 115 trust which is an alternate vehicle for paying for health care benefits. This vehicle differs from § 401(h) in two ways. There is no limit to the amount of money that can be put into it and there is no restriction against commingling the investments. The Board voted to set up this trust and to transfer $25 million from surplus earnings to fund this trust, which would have covered 3-4 years of benefits. Mr. Grissom explained, however, that this trust has not been funded yet because CERS is still attempting to resolve an investment issue. He noted that CERS wanted this structure because Section 115 trusts are less restrictive that § 401(h).

Retiree health care costs. Mr. Grissom explained that the health care benefits are funded through CERS because CERS has $3 billion in assets, while the City has budget problems. Mr. Grissom stated that there was no cost estimate done for the health care benefits at the time the City undertook to provide this benefit, although he noted that he (Grissom) had an estimate prepared by the former actuary, Buck Consultants, in 1989. Mr. Grissom said that the bottom-line numbers were about $300 - 500 million for this benefit, which would have represented a 5% contribution rate at that time. Mr. Grissom had asked the actuary to run these numbers so that he could get a general idea about the size of the benefit. In his previous position, Mr. Grissom had not worked with health benefits, so he did not know what to expect.

Mr. Grissom explained that there are many problems in trying to actuarially value future health benefits for the City of San Diego, because of the various different plans that are in effect. Another key issue governing whether to actuarially value the benefit is whether the retirement health benefit is vested at all, and if so, what is the precise benefit that is vested.

According to Mr. Grissom, certain retirees claim that they were promised healthcare benefits in 1982. Initially, pre-1982 retirees did not have healthcare benefits, but they were later granted benefits capped at $1,200 per year. Mr. Grissom explained that this particular benefit was priced out and that the liability is not significant because this is a closed group of retirees that gets smaller every year.

Rules Committee Report. Mr. Grissom explained that he made a presentation to the Rules Committee on February 12, 2003, which included a $1.1 billion cost estimate for future retiree health benefits. Mr. Grissom characterized this number as a "wild guess" that he had prepared in conjunction with the actuary, in order to present the full picture of potential liability. The $1.1 billion figure was based on several assumptions: (1) that every retiree who is eligible for retirement benefits will accept them, (2) that health insurance premiums would be $500 per month to start, and (3) that premiums would increase at 5% per year.

Mr. Grissom noted that the first assumption, that all retirees would accept the benefit, is conservative because many retirees have better options elsewhere. For example, former military employees or people who can get benefits through their spouses might have better benefits. At present, only 3600 of 5500 eligible retirees are on health benefit plans. The assumption concerning the cost of premiums is also conservative. He noted, however, that the 5% per year estimate for health premium increases was probably low and that costs would increase much more quickly. He stated that the 5% assumption was used because actuaries tend to be reluctant to use larger figures in projections of the future, because larger numbers yield extreme results for long-term time horizons. According to Mr. Grissom, Mr. Roeder's cost estimate was between $700 million and $1.2 billion for this benefit.

Mr. Grissom was not aware of any cost estimates for retiree health benefits generated between 1989 to 2003, aside from the Buck Consultants report and the Rules Committee Report, but was unaware whether or not the City had done any projections on its own.

MP I. Mr. Grissom explained that there is a diversity of views regarding the reasons that MP I was adopted. Mr. Grissom attributed one view to Jack McGrory. According to Mr. Grissom, that view is that the City was beginning to experience volatility in ARC and, as a result, the City needed to protect itself from this fluctuation. MP I was thus intended to stabilize the City's contribution rate.

As background, Mr. Grissom explained that, in the early 1990's, the City had converted from EAN to PUC financing. These are both included in the six accepted methods of valuing actuarial liabilities. The EAN method is the most commonly used valuation method and is the second-most-conservative approach. It also yields the most stable contribution rates. PUC, in contrast, revalues liabilities every year and, as a result, is more volatile. If a system converts from EAN to PUC funding, however, it experiences an immediate savings because the PUC rate is lower that the EAN rate in early years. The PUC rate increases faster than the EAN rate and they eventually cross and PUC becomes more expensive. Mr. Grissom explained that the PUC method is more volatile because of fluctuations in the attained age of the system, and that the Retirement Board made the decision to change from EAN to PUC funding.

As an aside, Mr. Grissom explained that the average attained age of CERS members is between 41 and 42, which is very, very high. This reflects the fact that turnover at the City is extremely low and, as a result, the contribution rate has increased more quickly than anticipated. Although the City went to PUC to get an initial cost savings, the volatility associated with the increased attained age caused it to exceed the EAN level much more quickly that it expected – in two years rather than six to seven years. Mr. Grissom noted that the increase in attained age of one-half year every year has a dramatic actuarial effect for PUC valuation and that this yielded rapidly increasing ARCs. Mr. Grissom also noted that the actuary wanted assumption changes for the pension system at the time of MP I that would have substantially increased contribution rates.

Mr. Grissom explained the second perspective on MP I by noting that the EAN to PUC conversion was associated with benefits increases. The conversion to PUC led to contribution relief at the same time the City promised increased retirement benefits. He also noted that shortly prior to MP I the California Supreme Court had issued its *Claypool* decision, which allowed government units to withdraw certain retirement benefits if additional and comparable benefits were provided at the same time. Mr. Grissom explained that Mr. McGrory was aware of *Claypool*, and MP I was designed to take advantage of that decision to allow benefit increases that did not have to be funded at that particular time. From Mr. Grissom's perspective, it was good to package MP I with the benefit increases because the whole package went to a vote of the membership, which approved it.

Mr. Grissom provided a layman's explanation of the contribution rate structure of MP I, which took the 1996 (or 1995) contribution rate and added 50 basis points per year in increased contributions. The initial MP I contribution rate was, however, less than the ARC. Mr. Grissom explained that reason the City wanted this contribution relief is that it is always under financial pressure, in addition to needing some predictability about its future contributions. Mr. Grissom explained that MP I also included a failsafe; contribution rates would continue unless there was a 10% decrease in the funding ratio, from 92.3% to 82.3%. The view at the time was that the MP I trigger would address any future funding problems the system encountered.

Mr. Grissom explained that, in his view, the key problem with MP I was that it lacked any sunset date, which was an issue that no one thought of at the time, in part due to high investment returns.

Accounting issues. Mr. Grissom stated that even though the City was paying less than the full actuarial rate, it still needed to figure the ARC. This is because the ARC figure defines the level of underfunding, and underfunding liability must be tracked and entered onto the City books as NPO. Mr. Grissom thought that CERS needed to report this figure in its financial statements as well, but later learned that this was unnecessary. Mr. Grissom explained that the actuary's 40-year amortization period for NPO is acceptable under generally accepted actuarial standards. Even though the amortization period is different from the one used to calculate ARC, NPO is a discrete calculation and the use of a different amortization period is appropriate.